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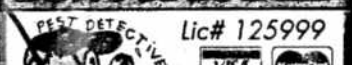
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Granholt's Proposal to Provide State-Run 401(k) Plan for Small Employers is Wrong for Michigan

By Lee M. Kliebert, JD, CPC, AIF(r)

GOVERNOR GRANHOLM'S RECENT PROPOSAL TO PROVIDE A STATE-RUN 401(K) PLAN FOR SMALL EMPLOYERS IS THE WRONG IDEA AT THE WRONG TIME FOR THE WRONG REASONS.

The governor would like us to believe that small businesses do not have 401(k) plans because they are too expensive for small employers to administer. While it is true that too many small employers do not sponsor retirement programs, the costs involved in plan administration are hardly the reason.

401(k) plans come in many different varieties, distinguished from each other by plan design features, available investments and varying levels of service and administrative costs. The variety of offerings is necessary to provide options to employers of all sizes and circumstances. The private sector has provided the necessary array of solutions to any employer seeking the 401(k) plan that is right for them.

In addition to 401(k)'s, there are a wide variety of other plans that require little or no administration that employers can take advantage of. Simplified Employer Pension Plans (SEP/IRAs), Simple IRA's, Individual (k)s, Traditional IRA's and Roth IRA's all provide variations on the 401(k) theme to address different circumstances.


Can an employer get confused by all these choices? Certainly. Does that make any of the choices less viable as a potential solution? Not at all.

Choosing the correct plan is complex because the circumstances inside each small business are as different as the individuals who own each business. Is the State ready to step in and consult with each employer to make sure they make the appropriate choice for them? Apparently not. 401(k) appears to be the universal answer in Governor Granholt's eyes. The biggest problem with this approach is that one size definitely does not fit all.

Many small employers do not sponsor 401(k) plans because the regulations that govern allowable contributions to 401(k) plans do not fit their economics or demographics. The bottom line is that unless the lower paid employees within an organization make salary deferral contributions at an acceptable level, the ability of the business owner to make contributions will be severely restricted or eliminated. The testing that must be performed annually to make this determination is complex. Employers can avoid these complex tests and contribution restrictions by agreeing in advance to make annual contributions to their employees accounts which are 100% vested. These so-called "safe harbor" contributions make 401(k) plans unaffordable for many small business owners that need the provisions to ensure that they can actually take advantage of the plan themselves. The State cannot remove these contribution restrictions simply by sponsoring a plan.

Many small business owners will still be faced with the unattractive choice between not making contributions to their own personal account, and making substantial contributions to the accounts of their employees in

order to allow their own deferral contributions to remain in the plan. I suspect that the governor's plan will actually make this choice for the business owner.

The governor's proposal for a state-sponsored 401(k) plan leads to many other questions with no real good answers. What makes the State think it should be involved in the administration of private sector pension plans that are governed by federal laws and regulations? 401(k) plans require a lot of service, both at the plan sponsor and the participant level. Who is going to provide the level of service necessary to make these plans successful? Even if the State contracts this out to a private sector vendor, who will conduct the due diligence reviews necessary to make sure the plan remains competitive? Ultimately, will the State be effectively accountable for the decisions it makes as would a fiduciary from the private sector? These are tough questions with no good answers. Maybe that explains why the federal government leaves the administration of these programs where it belongs – in the private sector. 

ABOUT THE AUTHOR



Lee Kliebert is Managing Partner at PensionTrend Investment Advisers, LLC, in Okemos.

Local Government Legacy Costs: A Time Bomb That's Ticking in Michigan

By Earl Ryan

GASB 45. IF YOU ARE NOT A GOVERNMENT FINANCE WONK, YOU PROBABLY HAVE NEVER HEARD OF IT.

It is, however, likely to have over the next few years an unprecedented impact on both state and local government finances and employee benefits, not only in Michigan, but across the nation.

GASB is the Governmental Accounting Standards Board, the public sector equivalent of the private sector Financial Accounting Standards Board (FASB). In June 2004, it issued its Statement No. 45, which deals with Other Post Employment Benefits (OPEB). GASB 45 requires reporting of the accrued liabilities of public employee retirement benefits other than pensions, most notably retiree health care insurance. Large units must begin in 2007, with smaller units coming on line over the next two years.

Those familiar with private sector accounting will recognize a parallel with FASB 106, issued 15 years ago, which required publicly traded companies to change their accounting for post retirement benefits from pay-as-you-go to accrual. The resulting massive increases in liabilities precipitated widespread changes in corporate employee benefit structures ranging from increased employee cost sharing to termination of retiree health care benefits, at least for new hires. Many public employee unions fear a similar result in the public sector as a result of GASB 45.

It has long been the practice to recog-

nize the accrued liabilities of defined-benefit pension plans. The costs, though significant, are predictable and funding the benefits as they are earned in order to assure that the money is available when the employee retires has been the standard way of meeting those obligations. There are, of course, underfunded plans, but the degree of underfunding can be easily determined.

Retiree health care benefits are another story. When first offered by governmental units, health insurance policies for retired public employees amounted to only a few tenths of a percent of payroll and paying for them on a pay-as-you-go basis seemed a manageable policy. As the cost of those benefits began to creep up, very few

perhaps because they do not really want to have to come to grips with the problem. The available estimates are breathtaking. The *New York Times* has cited one study that estimates the national state-local liability for retiree health care benefits at \$1 trillion.

Retired Public School Employee Health Benefits: A Case Study

To its credit, the Office of Retirement Systems in the Michigan Department of Management and Budget has for several years calculated the accrued liabilities of retiree health care benefits in the plans that it manages, enabling us to track the development of the funding shortfall for retiree health care benefits and to project its future course.

While a handful of local government units has begun to fund retiree health care benefits, the vast majority has not and many of these units face bleak fiscal futures unless they adopt policies to bring the cost of the benefits they have promised in line with the means of financing those benefits.

governmental units took the step of adopting programs of advance funding. These benefits now rival pension benefits in their cost and their funding is becoming a major public policy problem. Moreover, much of what we think we know about the accrued condition of public retiree health plans is based on the few plans that have actuarially valued the future costs of their benefits. Most local units have not performed such valuations, in some cases

Based, in part, on those calculations, in September 2004, the Citizens Research Council of Michigan issued a report, *Financing Michigan Retired Teacher Pension and Health Care Benefits*, which outlined the problem faced by the Michigan Public School Employees Retirement System (MPERS). This one plan is almost certainly a harbinger of problems in other public plans.

In Fiscal Year 1984-85, accrued pension liabilities in MPERS amounted to

\$9.5 billion, but there were assets in the fund of \$7.6 billion, leaving unfunded liabilities of \$1.9 billion. Accrued health care benefits were lower, \$1.5 billion, but no assets had been set aside to fund those benefits. Since then, accrued pension liabilities have grown to approximately \$46 billion. But, with \$39 billion in assets, MPSERS pension benefits are actually more soundly funded than they were in FY85. By contrast, the accrued liability for health care benefits has roughly doubled every five years since FY85 and no assets have been set aside to fund those benefits. As of FY04, the unfunded accrued liability of MPSERS health care benefits was \$16 billion, nearly three times the size of the unfunded pension liability.

In the current fiscal year (FY06), the required contribution to fund MPSERS pension benefits equals 10.2 percent of the active payroll of approximately \$10 billion. This is up from 6.12 percent in FY02, the increase resulting from poor performance of the stock market in 2001 and 2002. The contribution is projected to rise to 12.5 percent by FY09 and then to level off at 12.1 percent as the current improved stock market is reflected in the actuarial determination of MPSERS assets.


The contribution for retiree health care benefits in the current year equals 6.6 percent of payroll, or about two-thirds of the pension contribution. Because health care benefits are on a pay-as-you-go basis, however, the outlook for these costs is far different from that for pensions. Projections indicate a continual rise resulting in health care contributions exceeding those for pensions by FY14 and

claiming 19.9 percent of payroll in FY20. The total of pension and retired employee health care costs would be nearly double today's costs as a percent of payroll and far more than that in dollars. These costs are the responsibility of local school districts, but they are ultimately paid for by the state through state school aid.

The choices available to policy-makers are exceedingly difficult. One option is to begin a program of advance funding of the benefits, which in the short run would increase the annual health care contribution from less than seven percent to more than 15 percent of payroll, but which would then be stable into the future. Another option is to remedy an existing inequity in the way in which retiree health care benefits are earned. At present, it is possible for an individual to teach for five years and qualify for the same retirement health care benefit received by someone who had taught for 30 years. Substantial savings and greater equity could be achieved by requiring health care benefits to be earned at a rate of three percent per year of service to a total of 90 percent after 30 years.

The Outlook

The Michigan Legislature has begun to deal with this problem. A plan to require retiree health care benefits for school employees to be earned at a rate of three percent per year has generated much controversy but has made progress in the House of Representatives (as well as a provision for a defined contribution pension plan for teachers.) This echoes a similar policy adopted for state employees in 1997.

This is a positive step. But large unfunded accrued liabilities remain in MPSERS and in the Michigan State Employees Retirement System (MSERS) and their growth must be brought under control. (MSERS has an unfunded liability of \$6.8 billion and placing it on an actuarially sound funding basis would require annual contributions of more than 18 percent of payroll.) Further, as GASB 45 begins to reveal the extent of retiree health care underfunding in units of local government, we will almost certainly find that, while a handful of local units has begun to fund retiree health care benefits, the vast majority has not and many of these units face bleak fiscal futures unless they adopt policies to bring the cost of the benefits they have promised in line with the means of financing those benefits. 

ABOUT THE AUTHOR



Earl Ryan is President of Citizens Research Council, a private, not-for-profit public affairs research organization established in 1916 to provide nonpartisan analysis of state and local government organization and finance in Michigan.

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